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No. 303

In the Supreme Court of the United States

OCTOBER TERM, 1942

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

AMERICAN DENTAL CO.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

INDEX

CITATIONS

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The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit entered in the above entitled case on May 15, 1942, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 38–42) is reported in 44 B. T. A. 425. The opinion of the Circuit Court of Appeals (R. 47–50) is reported in 128 F. (2d) 254.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 15, 1942 (R. 51). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether creditors' cancellations in 1937 for business reasons of debts for past due rents and interest owed by the taxpayer and accrued and deducted as business expenses in its returns for years prior to 1937 resulted in taxable income to the taxpayer or, as held by the Circuit Court of Appeals, constituted gifts which were exempt from income tax.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Revenue Act of 1936, c. 690, 49 Stat. 1648, and of Treasury Regulations 94, promulgated under the Act, are set forth in the Appendix, *infra*, pp. 11–12.

STATEMENT

The Board of Tax Appeals found the following facts (R. 38–40): The respondent taxpayer is a corporation engaged in operating a laboratory where it does prosthetic work for the dental profession. For a number of years it has occupied space in the Mallers Building in Chicago. In December 1933 it negotiated a new lease which re-

duced the annual rental from $15,200 to $8,400. There was then due from the taxpayer $15,298.99 in back rent. Its president notified the rental agent that it was unable to pay all of that amount and requested an adjustment. The agent said that he would make an adjustment. The taxpayer regularly paid the rent under the new lease and in April 1934 the agent advised the taxpayer that he would accept $7,500 in payment of the back rent and would cancel the remainder. In 1937 taxpayer paid $7,500 in discharge of the back rent and for the first time made an entry on its books showing that back rent in the amount of $7,798.99 had been forgiven. In the same year the landlord likewise for the first time made an entry on its books cancelling the back rent in that amount (R. 38–39).

The taxpayer kept its books and made its returns upon an accrual basis of accounting. During the years prior to 1934 in which it had failed to pay its rent, it had regularly accrued the rent on its books and taken deductions therefor in its income-tax returns. Those deductions served to offset income in like amounts for those years (R. 39).

In November 1936 taxpayer was indebted to several creditors for merchandise which they had furnished it over a period of years and for which it had given its interest-bearing notes. It had been a good customer of these creditors for many years. During the month mentioned it requested

three of these creditors to cancel interest on the notes on the ground that they had made similar arrangements with their other customers. The three creditors agreed to cancel all interest accruing after January 1, 1932. The first entry that the taxpayer made on its books showing that the interest had been forgiven was made in December 1937 when the accounts payable to the three creditors were credited with a total of $16,947.74 representing interest on the notes accruing after January 1, 1932. All of this amount had been deducted by the taxpayer in its returns for the years, including 1936, during which the interest had accrued. The deductions had offset income on those returns to the extent of $11,435.22 (R. 39–40).

Neither in its return for 1937 nor in any other return did taxpayer report any of the cancelled rent or interest as income. The Commissioner in determining deficiencies in income and excess profits tax for 1937 held that the cancelled items constituted taxable income for that year to the extent that they had served to offset income in prior years. Accordingly, he included in taxpayer's income for 1937 the forgiven rent in the amount of $7,798.99 and the cancelled interest in the amount of $11,435.22 (R. 40).

The Board stated in its opinion that no evidence was introduced to show a donative intent on the part of any creditor and that the evidence indicated that the creditors "acted for purely business reasons and did not forgive the debts for

altruistic reasons or out of pure generosity" (R. 42). Holding that there was no gift, it affirmed the action of the Commissioner in treating the items as taxable income for 1937 and in determining deficiencies (R. 42).

The Circuit Court of Appeals for the Seventh Circuit reversed the decision of the Board on the ground that the cancellations constituted gifts exempt from income tax since, as the court concluded, they were made without consideration and for the taxpayer's benefit (R. 50).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the cancellations of past due indebtednesses for interest and rent constituted gifts exempt from income tax.

2. In failing to hold that the cancellations resulted in taxable income.

3. In relying upon Article 64 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, instead of Article 22 (a)–14 of Treasury Regulations 94, promulgated under the Revenue Act of 1936.

4. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. Decisions of this Court and of the lower federal courts have established that in a variety of circumstances similar to those presented by the instant case a debtor realizes taxable income when the debt is forgiven or settled or otherwise sat-

isfied for less than its face value. These decisions usually have been based either on the theory that there is an accession to income in that assets of the debtor are made available for other purposes (*United States* v. *Kirby Lumber Co.*, 284 U. S. 1; *Helvering* v. *American Chicle Co.*, 291 U. S. 426)[1] or on the theory that a restoration to income should be required where, as in the present case, deductions on account of the debt were taken in the debtor's returns for prior years and had the effect of offsetting income for those years. *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 352.[2] Whichever of these theories be deemed ap-

[1] Interest forgiven (*Helvering* v. *Jane Holding Corp.*, 109 F. (2d) 933 (C. C. A. 8), certiorari denied, 310 U. S. 653, rehearing denied, 311 U. S. 725; *Walker* v. *Commissioner*, 88 F. (2d) 170 (C. C. A. 5), certiorari denied, 302 U. S. 692); principle of indebtedness forgiven or settled by compromise (*Haden Co.* v. *Commissioner*, 118 F. (2d) 285 (C. C. A. 5), certiorari denied, 314 U. S. 622; *United States* v. *Little War Creek Coal Co.*, 104 F. (2d) 483 (C. C. A. 4)).

[2] Items deducted as expenses for which there was subsequent reimbursement (*Buffalo Union Furnace Co.* v. *Helvering*, 72 F. (2d) 399, 403 (C. C. A. 2)); settlement with employees for less than amounts previously deducted as expense (*Commissioner* v. *Vandeveer*, 114 F. (2d) 719, 722–723 (C. C. A. 6)); debts deducted as bad in prior years and subsequently paid (*Commissioner* v. *Liberty Bank & Trust Co.*, 59 F. (2d) 320 (C. C. A. 6)); *Askin & Marine Co.* v. *Commissioner*, 66 F. (2d) 776 (C. C. A. 2)); wages deducted as expense but uncollected are income when subsequently charged back to profit and loss (*Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7), certiorari denied, 284 U. S. 618; *Charleston & W. C. Ry. Co.* v. *Burnet*, 50 F. (2d) 342 (App. D. C.)); unclaimed deposits credited to surplus (*Boston Consol. Gas Co.* v. *Commissioner*, 128 F. (2d) 473 (C. C. A. 1)).

plicable here, or whether both be, the decision of the court below represents a departure from the uniform result reached in the cases cited.

2. In holding that the cancellations of rent and interest constituted gifts exempt from income tax, the decision is in conflict with *Haden Co.* v. *Commissioner of Internal Revenue*, 118 F. (2d) 285 (C. C. A. 5), certiorari denied, 314 U. S. 622, and is erroneous. The creditor corporation in the *Haden Co.* case cancelled an indebtedness for the purchase price of materials and for rent owed by the taxpayer company. The latter had the same stockholders and officers and directors as the creditor and was engaged in selling the creditor's products to the retail trade. The Board of Tax Appeals found that the cancellation, although voluntary, was made in recognition of business benefits which would result and was not a gift.[3] The Circuit Court of Appeals for the Fifth Circuit sustained this finding as proper and affirmed the Board's holding that the cancelled debt, which the taxpayer had deducted in its returns for prior years, was taxable income in the year of cancellation to the extent that it made the taxpayer solvent.

The conflicting decision of the court below in the instant case is based (a) on the court's assumption that a gift within the meaning of the statu-

[3] The memorandum decision of the Board in the *Haden Co.* case is not reported but is included in the record (pp. 14–18) in the case on file in this Court, No. 171, October Term, 1941.

tory provision excepting property acquired by "gift, bequest, devise, or inheritance" from the definition of income is exempt from tax as income even though the taxpayer took deductions which offset income in prior years; and (b) on the court's holding that such a gift must necessarily be intended if the cancellation is without consideration and if, as would always be the case, it benefits the debtor.

Assuming, but not conceding, that the court's assumption is valid, its holding plainly goes beyond established law,[4] as was recently said by the Circuit Court of Appeals for the Third Circuit in commenting upon the decision.[5] The voluntary character of a payment or of a discharge of indebtedness is not alone sufficient to establish it as a gift. There must be a donative intent and this is not present where payments or discharges are motivated by business considera-

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[4] The court erroneously stated in its opinion that (R. 49): "The Government freely conceded that unless the forgiveness of indebtedness in each of these instances was based upon a consideration, it would amount to a gift, and gifts are not taxable as income to the donee." No such concession was made on brief or otherwise. However, the court denied a motion to delete the statement from the opinion (R. 51–52).

In its opinion the court also relied upon Article 64 of Treasury Regulations 77, promulgated under the Revenue Act of 1932. The applicable regulation is found, however, in Article 22 (a) 14 of Treasury Regulations 94, promulgated under the Revenue Act of 1936.

[5] *Sportswear Hosiery Mills* v. *Commissioner* (C. C. A. 3), decided June 25, 1942, not officially reported but found in 1942 C. C. H., Vol. 4, Par. 9565, fn. 29.

tions; it is present only where they are made without "incentive of anticipated benefit of any kind beyond the satisfaction which flows from the performance of a generous act." Cf. *Bogardus* v. *Commissioner*, 302 U. S. 34, 41, and cases cited in footnote.[6]

Although in the instant case the burden of proof was on the taxpayer,[7] the Board stated that the evidence failed to show a donative intent but indicated, on the contrary, that the cancellations were made for business reasons (R. 42). Since this is an inference of fact and is supported by the evidence with respect to the business relationships existing between the taxpayer and its creditors and with respect to the manner in which the cancellations were sought and obtained, it was conclusive on the court below. To the extent that the court failed to adopt the Board's finding, its decision conflicts with the familiar rule recently applied in *Wilmington Trust Com-*

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[6] *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 730; *Sportswear Hosiery Mills* v. *Commissioner*, *supra*; *Fitch* v. *Helvering*, 70 F. (2d) 583, 585 (C. C. A. 8); *Noel* v. *Parrott*, 15 F. (2d) 669, 671 (C. C. A. 4); *Weagant* v. *Bowers*, 57 F. (2d) 679 (C. C. A. 2); *Fisher* v. *Commissioner*, 59 F. (2d) 192 (C. C. A. 2); *Bass* v. *Hawley*, 62 F. (2d) 721 (C. C. A. 5).

"The instances are many in which purpose or state of mind determines the incidence of an income tax." *Helvering* v. *National Grocery Co.*, 304 U. S. 282, 289.

[7] *Reinecke* v. *Spalding*, 280 U. S. 227, 232–233; *Burnet* v. *Houston*, 283 U. S. 223, 227–228; *Welch* v. *Helvering*, 290 U. S. 111, 115; and *Fitch* v. *Helvering*, 70 F. (2d) 583, 585–586 (C. C. A. 8).

pany v. *Helvering*, decided April 27, 1942, No. 775, October Term, 1941.

CONCLUSION

It is respectfully submitted that this petition for a writ of certiorari be granted.

CHARLES FAHY,
Solicitor General.

AUGUST 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:

* * * * *

(3) *Gifts, Bequests, and Devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income); * * *

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 22 (a)—14. *Cancellation of indebtedness.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an in-

dividual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22 (a)—18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. * * *

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